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TAGS: ECON EFIN ETRD EINV PGOV PREL BR
SUBJECT: Private Sector Optimistic for Brazilian Economy in 2010

REF: 09 SAO PAULO 624; 09 SAO PAULO 630; 09 BRASILIA 950
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¶1. (SBU) Summary: Brazilian private sector analysts see a bright economic outlook for 2010 with GDP growth nearing six percent, inflation remaining within target, and strong job creation. Boosted by the enduring impact of GOB stimulus measures implemented to weather the global economic crisis and strong domestic consumer demand, Brazil has emerged from the financial crisis earlier and more robustly than most countries. While inflation pressures and a strong currency pose moderate short-term risks, business contacts contend that sustained high rates of growth beyond 2010 are dependent on curbing the growth in GOB spending, progress on long-pending tax and labor reforms, and boosting infrastructure investment. End Summary.

2009 Ending Positive

¶2. (SBU) While final data is not complete, most private sector analysts agree Brazil's economy closed 2009 on a positive note. Despite the global economic crisis' immediate effects on the Brazilian economy, the GOB was able to implement timely countercyclical measures (e.g. interest rate cuts, tax cuts, increased fiscal transfers to households, and softening lending restrictions, etc.) that prevented the external shock from reaching deeper into employment and income (ref C). Brazil's economy came out of a recession in the second quarter of this year, growing by 1.9 percent of GDP, and the Central Bank estimates that total annual growth may finish positive at around 0.2 percent. According to a study by leading Brazilian bank Itau-Unibanco, without the GOB economic stimulus measures the economy would have shrank 3.2 percent.

Economic Growth Likely to Reach Pre-Crisis Levels

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¶3. (SBU) Building off 2009 momentum, the Brazilian economy is likely to attain GDP growth levels of around 5.5 percent in 2010. Some of our contacts, such as Brazil's Central Bank (BCB) Senior Analyst Alexandre Pundek and Itau Bank Economic Analyst Mauricio Oreng, are even predicting about six percent GDP growth fueled by high domestic demand. They also cite as drivers the enduring economic stimulus measures the BCB and the Lula administration adopted in 2009 to weather the global economic crisis. Santander Bank Chief Economist Alexandre Schwartsman says these measures are likely to stimulate consumption, output, capacity utilization and investment well into 2010. Echoing the point, an Itau-Unibanco study indicates that without the GOB stimulus measures and their multiplier effects, the 2010 GDP growth outlook would only reach 3.7 percent.

¶4. (SBU) With respect to trade, business leaders expect both total exports and imports to increase in 2010 as the global economy rebounds. According to the Federation of the Industries of the State of Sao Paulo (FIESP), exports are likely to increase by 16 percent from the current $152 billion whereas imports are likely to increase by 30 percent from the current $128 billion, due to the strength of the Brazilian currency and slower global economic growth than Brazil. Nonetheless, FIESP expected Brazil to register a trade surplus of $10.5 billion, down from $24 billion in 2009.

Output Growth Likely to Boost Job Creation

¶5. (SBU) Brazil is also ending the year with a positive job creation record, despite the recession in early 2009. According to the Brazilian Labor Ministry 1.3 million jobs were created this year, pushing the unemployment rate down from 7.9 to 7.4 percent. Alexandre Schwartsman attributes the Brazilian labor market's resiliency to two key factors. First, companies were reluctant to let go of workers despite a decline in industrial production due to perceptions that the slowdown would be short-lived. Second, companies wanted to avoid incurring the high cost of firing and hiring workers, choosing instead to keep workers even if underutilized. Meanwhile Schwartsman estimates around 2 million jobs will be created in 2010 as industrial output rebounds further.

Central Bank Tightening to Contain Inflation

¶6. (SBU) Amid the positive outlook, the private sector is increasingly expecting the Central Bank to start raising interest rates from their historic lows to contain inflation risks. According to Schwartsman from Santander, if economic growth for the first quarter approaches six percent, then the Central Bank will almost certainly raise its benchmark rate early in the second quarter. Yet, if the economy grows closer to five percent, then he expects the tightening process will start mid-year. Most other contacts agree that inflation risks are likely to surface in 2010, as higher economic growth reduces the output gap, with some like Itau's analyst Oreng predicting that the Central Bank will raise its benchmark as high as 10.75 percent, or about 200 bases points higher than this year's rate, to protect the inflation target of 4.5 percent.

Currency to Experience Minor Election-Year Volatility

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¶7. (SBU) While export industries continue to fret about the strength of the Brazilian Real (ref A), up 34 percent against the U.S. dollar in 2009, most of our financial sector contacts predict the Real will remain strong and not depart significantly from its 2009 closing of 1.73 R$/USD for most of 2010. Nevertheless, the Real may experience some minor volatility in the run up to national elections in October, and as the GOB continues to search for ways to quell the Real's appreciation. A Ministry of Finance official said January 4 that the GOB has allowed Brazil's sovereign wealth fund to invest in U.S. Dollars, representing another move by the GOB to try and stop Real appreciation, but perhaps more significantly gives the Ministry of Finance a tool to control the national currency, an activity that traditionally resides within the Central Bank. Schwartsman from Santander predicts the Real will likely depreciate to 1.8 Reais per dollar, due to election volatility.

Economic Risks Could Hamper Long-Term Growth

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¶8. (SBU) Despite the positive outlook, some in the business community worry that the heady recovery expected in 2010 is unsustainable in the long-run unless Brazil tackles deeper structural issues including fiscal account deterioration caused by increased government spending, and competitiveness and efficiency shortcomings caused by burdensome labor and tax regulations and failing infrastructure (ref D). In a recent luncheon hosted by the Consul General, prominent businessman Roberto Teixeira da Costa lamented the lack of progress on an economic reform agenda, a tendency by the GOB toward greater policy interventionism, and concern that prospects for much-needed amendments to simplify the labor code and tax system were slim in the upcoming electoral cycle (NOTE: Congressional opposition, unwilling to award additional political victories during the Lula administration's final months, will make passage of any significant reform measures unlikely this year. END NOTE). Alexandre Pundek told econoff in Brasilia that the Central Bank is concerned about permanent spending increases that are taking place within the GOB in government payroll and personnel. The Central Bank and the Ministry of Finance are counting on a strong recovery in tax collections to keep additional fiscal erosion at bay. (NOTE: the latest data for tax collections in October and November were both recent record highs. END NOTE).

¶9. (SBU) Meanwhile, Brazil's rate of investment, particularly in infrastructure, is failing to keep pace with demand. Despite its impressive recovery from the recession, Brazil continues to lag investment in fixed capital as well as in infrastructure. While FIESP estimates 2010 investment will account for 19 percent of Brazil's economy, an increase from 2009, much of the boost will likely be driven by planning for the upcoming World Cup and Rio Olympic Games, as well as offshore pre-salt oil projects. FIESP and other contacts acknowledge that long-term investment remains too low, considering IMF calculations that developing economies in Asia invest about 42 percent of their respective GDP and the world's investment average is 24 percent. According to Luis Fernando Lopes, chief economist at Patria Investimentos, Brazil will need to invest about 23 percent of GDP annually to sustain economic growth at five percent over the longer term.

Comment

¶10. (SBU) Spurred by government stimulus measures, the increased purchasing power of a strong Real, and a burgeoning middle class (ref B), Brazil's domestic market, more and more the country's key economic growth engine, is poised for a strong year. Given the

broad political consensus on sound macroeconomic policies among the country's leading candidates, any presidential election jitters are unlikely to have a major impact on the economy, aside from some minor currency volatility. Meanwhile, preparations for major offshore oil development in the pre-salt region, the 2014 World Cup, and the 2016 Olympic Games represent an opportunity to spur much-needed public investment. However, private sector analysts make a cogent argument that broad structural tax and labor reforms, along with infrastructure improvements and fiscal constraint are necessary for Brazil to achieve sustained high rates of growth over the longer term. End comment.
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